UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. FABRICE TOURRE, Defendant.	x : : : : : : : : : : : : x	Civil Action No.: 10-cv-3229 (BSJ) (MHD) <u>ELECTRONICALLY FILED</u>

REPLY MEMORANDUM OF LAW OF FABRICE TOURRE IN FURTHER SUPPORT OF HIS MOTION FOR LIMITED RECONSIDERATION OF <u>THE COURT'S MEMORANDUM AND ORDER DATED JUNE 10, 2011</u>

Pamela Rogers Chepiga
David C. Esseks
Andrew Rhys Davies
Brandon D. O'Neil

ALLEN & OVERY LLP
1221 Avenue of the Americas
New York, New York 10020
(212) 610-6300

Attorneys for Fabrice Tourre

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New York, New York

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Defendant Fabrice Tourre respectfully submits this reply memorandum of law in further support of his motion for limited reconsideration of the Court's Memorandum and Order dated June 10, 2011.

SYNOPSIS

Mr. Tourre has shown that the Court's bifurcation of the unambiguously foreign IKB and ABN transactions into domestic "offers" and foreign "sales" cannot stand in light of *Morrison,* and that it is unsupported either by the statutory language and history, or by the cases cited in the Court's June 10 Order. *See* Tourre Mem. at 2-7.[1]

In response, the SEC advances a number of arguments that are addressed below. What the SEC cannot, do, however, is to cite a single case in the 78-year history of the Securities Act in which any court has, in any context, bifurcated a completed securities transaction into a "sale" and "offer" and held them to be separately actionable. Nor has the SEC even referenced a rule, interpretation or adjudication in which the SEC itself has ever split a completed transaction into its component "sale" and "offer" parts and treated them separately for any purpose.

As the Court erred in its ruling as to the Section 17(a) claim relating to the IKB and ABN transactions by overlooking both the controlling decision in *Morrison* and the language and legislative history of the Securities Act, Mr. Tourre's motion for reconsideration should be granted.[2]

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[1] Capitalized terms have the meanings assigned to them in the Memorandum of Law in Support of Mr. Tourre's Motion for Limited Reconsideration of the Court's Memorandum and Order Dated June 10, 2011 (D.E. 96) ("Tourre Mem.").

[2] Notwithstanding the SEC's footnoted argument, *see* SEC's Mem. of Law in Opp. to Def. Tourre's Mot. for Reconsideration ("SEC Opp."), at 5 n.1, Mr. Tourre is not seeking *re*litigation, but rather to litigate this important issue for the first time so that it can be decided with the benefit of briefing. Although the Court questioned at argument whether an offer can be "untethered" from a completed sale for *Morrison* purposes, *see id.*, the positions advocated by the parties were that the IKB and ABN transactions were either entirely foreign for *Morrison* purposes, *see, e.g.*, Mem. of Law in Support of Mr. Tourre's Mot. to Dismiss the Am. Compl. dated Dec. 9, 2010 (D.E. 52), at 10, or entirely domestic, *see, e.g.*, SEC's Mem. of Law in Opp. to Def. Tourre's Mot. to Dismiss the Am. Compl. dated Dec. 21, 2010 (D.E. 54), at 11-15. Certainly, no party provided any authority for the notion that *Morrison* permits those transactions to be bifurcated into foreign sales and domestic offers.

ARGUMENT

1. Morrison

Mr. Tourre has shown that *Morrison* holds clearly that the federal securities laws apply only to protect "parties or prospective parties," *i.e.*, purchasers and offerees, to domestic securities transactions. *See* Tourre Mem. at 3-5. There is no basis for the SEC's contention that the Supreme Court's language applies only to Exchange Act claims. *See* SEC Opp. at 8-9. To the contrary, immediately after writing that the Exchange Act protects only "parties or prospective parties" to domestic securities transactions, the Supreme Court wrote that "[t]he same focus on domestic transactions is evident in the Securities Act of 1933." *Morrison v. Nat'l Australia Bank Ltd.*, 130 S.Ct. 2869, 2885 (2010). As the IKB and ABN transactions are not "domestic" transactions, *see* Order at 21-28, 35-37, it necessarily follows that the alleged "offers" to enter into those transactions fall outside the purview of the federal securities laws.

Further, in response to Mr. Tourre's showing that the Court's ruling creates exactly the kind of regulatory multiplicity that *Morrison* sought to avoid, *see* Tourre Mem. at 4, the SEC mocks "Tourre's concern about 'regulatory multiplicity.'" *See* SEC Opp. at 10. It was, however, the United States Supreme Court, not Mr. Tourre, that expressed the "paramount concern" that a single securities transaction not be regulated by multiple jurisdictions, and that directed the courts to apply the securities laws so as to avoid that result. *See Plumbers' Union Local No. 12 Pension Fund v. Swiss Reins. Co.*, 753 F. Supp. 2d 166, 177 (S.D.N.Y. 2010) (Koeltl, J.) (citing *Morrison*, 130 S.Ct. at 2886). Under the SEC's approach and the June 10 Order, however, every U.S. securities firm and professional would be exposed to regulatory multiplicity every time they enter into an overseas transaction, simply because the slightest amount of U.S. preparatory conduct could be argued to satisfy the statutory definition of an "offer." That result would be wholly inconsistent with *Morrison*.

Finally, the Court should reject the SEC's late-stage suggestion that the absence of a private right of action under Section 17(a) warrants a relaxation of *Morrison*. *See* SEC Opp.

at 10. Nothing in Justice Scalia's majority opinion supports the SEC's suggestion that *Morrison* was focused narrowly on "ubiquitous private class action litigation." *Id.* To the contrary, *Morrison* focuses broadly on the geographical scope of the antifraud provisions of the federal securities laws, in which respect there is no difference between the SEC and private plaintiffs, and on the undesirability of exposing participants in the global securities markets to overlapping and mutually-inconsistent regulation. *See Morrison*, 130 S.Ct. at 2876-88.

Moreover, even if there were some basis for the SEC's proposal to apply some watered-down version of *Morrison* when there is no private claim under the relevant statute, which there is not, the SEC fails to recognize that Section 12 of the Securities Act, employing language analogous to that in Section 17(a), provides investors a private right of action against a defendant who "[o]ffers or sells" securities by means of a materially misleading prospectus or oral communication. *See* 15 U.S.C. § 77l(a)(2). Under the June 10 Order and the approach advocated by the SEC, an investor in a foreign securities transaction would apparently have a claim under Section 12 merely because an offer was made from the United States, as well as a claim for the same loss under the law of the jurisdiction where the transaction took place. That result would be utterly inconsistent with *Morrison*, as well as the Second Circuit's holding that "§ 12 does not reach further than § 10(b)." *See Europe and Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118, 128 n.10 (2d Cir. 1998), *abrogated on other grounds by Morrison*, 130 S.Ct. at 2879-83.[3]

2. <u>Statutory Language</u>

Unwilling to recognize the effect of *Morrison* on its Securities Act claim, the SEC instead clings desperately to the open-ended definition of "offer" in Section 2(a)(3) of the Act, in the vain hope that it somehow overrides *Morrison*. *See* SEC Opp. at 6-8.

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[3] *See also In re Royal Bank of Scotland Group PLC Sec. Litig.*, 765 F. Supp. 2d 327, 339 (S.D.N.Y. 2011) (dismissing Section 12 claims under *Morrison* because, even though the prospectus was filed with the SEC, there was no domestic securities transaction).

First, as the Honorable John G. Koeltl has held in analogous circumstances, the unhelpful definitions in the securities laws must be interpreted in context, and cannot, in any event, override *Morrison*'s crystal clear mandate that the federal securities laws apply only to domestic transactions. *See Plumbers' Union*, 753 F. Supp. 2d at 177-78 (holding that, notwithstanding its expansive statutory definition, "purchase" could not be interpreted, for *Morrison* purposes, so widely that a transaction would be domestic simply because a purchaser placed a buy order from the United States).

German bank IKB's Reg. S purchase of ABACUS 2007-AC1 notes from London-based GSI (constituting IKB's twenty-seventh Reg. S purchase of ABACUS notes), and a credit default swap between the London branch of ABN and GSI, entered into pursuant to a 1996 English-law governed agreement, are not domestic in any sense. *See* Tourre Mem. at 2-3; Order at 21-28, 35-37. In the context of *Morrison*, therefore, the offers to enter into those clearly foreign transactions simply are not subject to the federal securities laws.

Second, neither the June 10 Order nor the SEC cites any case law or other support for the view that the statutory definition of "offer" focuses on the offeror. *See* Order at 38; SEC Opp. at 6-7. To the contrary, the statute itself focuses neither on the offeror nor the offeree. Notably, however, when adopting Reg. S to exempt foreign transactions from the registration provisions of the Securities Act based on a "territorial approach" that is highly analogous to the "transactional test" that *Morrison* applies to the antifraud provisions,[4] the SEC placed the focus unambiguously on the location of the offeree. Indeed, the *Morrison* court itself cited a provision of Reg. S which states that the term "offer" does not include offers deemed to occur "outside the

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[4] In its Release accompanying the adoption of Reg. S, the SEC explained that a "territorial approach" to the registration provisions was appropriate because "[p]rinciples of comity and the reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore." Offshore Offers and Sales, Securities Act Release No. 33-6863, 1990 WL 311658, at *5 (Apr. 24, 1990). Similarly, in *Morrison*, the Supreme Court observed that other countries regulate securities transactions within their territorial jurisdictions, that regulatory approaches often differ from country to country, and that its "transactional test" was calculated to avoid the "interference with foreign securities regulation that application of § 10(b) abroad would produce." See *Morrison*, 130 S.Ct. at 2885-86.

United States." *See Morrison*, 130 S.Ct. at 2885 (citing 17 C.F.R. § 230.901). Reg. S provides that an offer occurs outside the United States where it "is not made to a person in the United States." *See* Tourre Mem. at 4 (quoting 17 C.F.R. §§ 230.903(a), 230.902(h)) (emphasis added). The SEC has also explicitly confirmed that domestic issuers may initiate "sales communications to non-U.S. persons from the United States" without losing the protection of Reg. S. *See id.* (quoting Offshore Offers and Sales, Securities Act Release No. 33-6863, 1990 WL 311658, at *n.65 (Apr. 24, 1990)) (emphasis added).[5] That it is expedient for the SEC to take a contradictory position in an effort to perpetuate this lawsuit does not constitute good reason for its change of position.

3. Case Law

Mr. Tourre has shown that the cases referenced in the June 10 Order, although readily adopted by the SEC in its opposition, *see* SEC Opp. at 6, do not support the Court's bifurcation of the completed IKB and ABN transactions into domestic "offers" and foreign "sales." *See* Tourre Mem. at 6-7.

Evidently, the SEC, like Mr. Tourre, has failed to identify any case in which any court has, for any purpose, bifurcated a completed transaction into separately actionable offer and sale components. The only additional case the SEC cites, *SEC v. Wolfson*, 539 F.3d 1249, 1264 (10th Cir. 2008), *see* SEC Opp. at 6, does not do so, holding only that Section 17(a) liability may arise even when there is no completed securities transaction. Even assuming, arguendo, that to be correct, no case holds, or supports the holding that completed securities transactions can be split into separately actionable "offers" and "sales."

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[5] Despite the SEC's mischaracterization, Mr. Tourre's argument is not based solely on the fact that the alleged offerees are foreign entities. *Cf.* SEC Opp. at 2. Rather, where, as here, an alleged offer has been consummated by a securities transaction that is undeniably foreign and, therefore, not subject to the federal securities laws, any "offer" to enter into that transaction cannot be bifurcated from the completed sale, and is therefore also outside the purview of those laws.

The June 10 Order therefore appears to be the only instance in the 78-year history of the Securities Act to reach such a conclusion. Mr. Tourre submits that this approach cannot stand.

4. <u>Legislative History</u>

Mr. Tourre has further demonstrated that the legislative history of the Securities Act confirms that Congress never intended that a completed securities transaction could be bifurcated into separately actionable "offer" and "sale" components. *See* Tourre Mem. at 5-6.[6] The SEC's argument that the legislative history supports the bifurcation of a completed transaction into separately-actionable "offer" and "sale" components, *see* SEC Opp. at 9-10, is unsustainable.

As the SEC concedes, as originally enacted, the Securities Act did not separately regulate "offers" and "sales" for any purpose. To the contrary, "sale" was defined to include "offer." *See id.*; Tourre Mem. at 5. There is, therefore, no basis to conclude that the Securities Act, as enacted in 1933, permitted a single transaction to be split into its "offer" and "sale" components, so that each component could be regulated separately.

In 1954, the term "sale" was redefined to exclude "offers," and the word "offer" was added to Section 17(a), as part of a "highly technical" amendment affecting principally Section 5 of the statute, which previously had forbidden the making of "offers" during the waiting period between the filing of a registration statement and its effective date. *See* Arthur H. Dean, *Twenty-Five Years of Federal Securities Regulation by the Securities and Exchange Commission*, 59 Colum. L. Rev. 697, 714-15 (1959). The amendment permitted and encouraged the dissemination, during the waiting period, of "offering" materials that would provide information to potential investors, albeit that no "sale" could take place until the registration statement became effective. *See id.*

[6] The SEC is in no position to object to the use of legislative history on the basis that the statute is clear, *see* SEC Opp. at 9, when its argument hinges on a statutory definition of the kind that the Supreme Court itself has called "unhelpful." *See* Tourre Mem. at 4 n.3.

As then-SEC Chairman Ralph H. Demmler and Commissioner J. Sinclair Armstrong explained, this amendment did "not work any fundamental change" to the Securities Act. *See* Ralph H. Demmler and J. Sinclair Armstrong, *The Federal Securities Laws: The Scope and Effect of the New Amendments*, 41 A.B.A. J. 133, 135 (1955).[7] Rather, these amendments permitted "written offers to sell and solicitations of offers to buy during the waiting period by means of a preliminary prospectus," a period during which a registration statement was not yet effective and the conclusion of any sales was thus prohibited. *See id.* at 134-35.[8]

Congress added the word "offer" to Section 17(a) purely to ensure its consistency with the amendments made to other sections of the Securities Act. *See* H.R. Rep. No. 1542 (1954), *reprinted in* 2 United States Code Congressional and Administrative News, 1954, at 2999 (1954) (listing as one of the "[t]echnical changes" in the 1954 amendments the addition of "the word 'offer' to sections 12, 17 and 22 of the Securities Act in order to make clear that the civil and penal liabilities and sanctions imposed by the statute shall remain unchanged.").

As the legislative history demonstrates, the term "offer" was added to Section 17(a) for the sole purpose of ensuring that, after the 1954 amendments, offers made during the waiting period (when sales still could not be consummated) would remain subject to the antifraud provisions of Section 17(a). Nothing in the legislative history supports the idea that Congress intended to create two separately-actionable claims under Section 17(a) with respect to a single consummated transaction.

The Court's Order, however, is directly contrary to Congress' stated intent and creates unauthorized law. The June 10 Order subjects participants in securities transactions to

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[7] As the Demmler and Armstrong article is not readily available on standard legal research databases, Mr. Tourre has attached it as Annex 1 to this memorandum of law.

[8] *See also* Morris L. Forer, *A Comment on the Amendments to the Federal Securities Acts*, 103 U. Pa. L. Rev. 1020, 1028 (1955) (noting that the 1954 amendments sought only to "remov[e] the difficult concept of the pre-October, 1954 practice: that it was permissive (and even obligatory under [SEC] administration) for an issuer or underwriter to disseminate information during the waiting period but that it was illegal to offer or solicit offers.").

double penalties—once for participating in a "sale" and again for its constituent "offer." But, as shown above, Congress did not intend such a result and the SEC has cited no case in which a defendant actually incurred two penalties for a single transaction, one for an "offer" and, separately, one for a "sale." The June 10 Order therefore constitutes the creation of both an offense and a penalty never authorized by Congress, which is precisely the kind of judicial lawmaking that has plagued the history of the federal securities laws and that the Supreme Court disapproved in *Morrison*. *See Morrison*, 130 S.Ct. at 2877-81.

5. <u>Prejudice</u>

Once again, the SEC insists that it does not matter that Mr. Tourre has been denied any ability to obtain documentary discovery from IKB, because the SEC has turned over to Mr. Tourre all documents it obtained from IKB. *See* SEC Opp. at 11. The problem, however, is that when the SEC sought documents from IKB, it was hardly motivated to seek documents to disprove its case or to support Mr. Tourre's defense. Under these circumstances, Mr. Tourre would be severely prejudiced by being required to defend a Section 17(a) claim as to the alleged IKB "offer."

Further, the effect of the June 10 Order is that the parties must now embark on, and, under the current tentative schedule, complete by November 18, 2011, costly, time-consuming international discovery of IKB and ABN that would be unnecessary under a correct application of *Morrison* and Section 17(a). Moreover, absent reconsideration, Mr. Tourre faces the further prejudice of litigating this matter under an incorrect standard of law that, unless corrected, will infect the summary judgment phase, the admissibility of evidence at trial, and the charge to the jury. Considerations of fairness and efficiency require that the error be corrected now.

CONCLUSION

For all the foregoing reasons, Mr. Tourre respectfully requests that the Court reconsider its Memorandum and Order dated June 10, 2011 and grant Mr. Tourre's Motion to Dismiss the SEC's Amended Complaint as to the Section 17(a) allegations pertaining to "offers" to IKB and ABN.

Dated: July 18, 2011
New York, New York

Respectfully submitted,

/s/ Pamela Rogers Chepiga

Pamela Rogers Chepiga
(pamela.chepiga@allenovery.com)
David C. Esseks
(david.esseks@allenovery.com)
Andrew Rhys Davies
(andrew.rhys.davies@allenovery.com)
Brandon D. O'Neil
(brandon.o'neil@allenovery.com)

ALLEN & OVERY LLP
1221 Avenue of the Americas
New York, New York 10020
(212) 610-6300

Attorneys for Fabrice Tourre

Annex 1

The Federal Securities Laws:

The Scope and Effect of the New Amendments

by Ralph H. Demmler and J. Sinclair Armstrong

The Securities Act of 1933 and the Securities Exchange Act of 1934 were substantially amended for the first time in more than a decade by the 83d Congress. The amendments became effective last October. This article by the Chairman and a member of the Securities and Exchange Commission is intended to acquaint the practicing lawyer with the changes effected by the new amendments.

Provisions of the federal securities acts vitally affecting the marketing of securities in interstate commerce were amended at the Second Session of the 83d Congress. The amendments are the first major changes in these laws in over a decade. The following is written to familiarize the Bar generally with the salient features of the changes.

By this legislation, sponsored by the Eisenhower Administration, recommended by the Securities and Exchange Commission and representatives of many business groups and passed unanimously by the Congress, certain provisions of the securities acts affecting the offering of new issues of securities and some other technical provisions of those laws were changed. The legislation was introduced by Senator Homer E. Capehart, of Indiana, Chairman of the Committee on Banking and Currency, and managed in the Senate by Senator Prescott Bush, of Connecticut, Chairman of the Subcommittee on Securities, Insurance and Banking. In the House it was managed by Representative Charles A. Wolverton, of New Jersey, Chairman of the Interstate and Foreign Commerce Committee. The bill (S. 2846) was signed into law by President Eisenhower on August 10, 1954, and became effective on October 10, 1954 (P. L. 577, c. 667, 68 Stat. 683, 83d Congress, 2d Session).

The good result produced by the Securities Act of 1933 has come in great measure from the fact that the issuer and the underwriter must come forward and make a public statement concerning the issuer's business, its finances, its securities and the proposed offering—and all of this under stern statutory liabilities, both penal and civil. This requirement of disclosure is itself a substantial deterrent to transactions that would not stand the light of day. The imposition of liability for inaccurate and incomplete information and the administrative processing by the Commission of material filed with it have improved corporate morality, accounting standards and standards relating to business information generally.

The present amendments in no way curtail the duty to disclose or the liability for non-conformity to the disclosure requirements, nor is there any decrease in the administrative powers of the Commission.

The most important change involves Section 5 of the Securities Act of 1933. Many of the other amendments are necessary to accommodate other sections of the Securities Act to the amendment of Section 5.

The change in Section 5 and the related changes have to do principally with the mechanics of the distribution of securities. These changes must be considered against the background of the Act before the amendment and practices thereunder.

The Securities Act before the amendment took effect made unlawful the offer or sale of a security to the public by mail or instrumentality of interstate commerce, such as the interstate telephone, until a registration statement with respect to the security had been filed with the Commission and become effective. Oral offers prior to effectiveness were not made unlawful by the Securities Act of 1933, that is, oral offers within the state. The period between the filing date of a registration statement and the effective date averages about twenty days. The seller of a security must deliver to the purchaser a prospectus containing a summary of the information in the registration statement.

It is clear from the legislative history of the Act that the Congress intended that by dissemination of information during the waiting period the public would become informed of the essential facts relating to a proposed issue before the effective date of the registration statement.

Illegal "Offers" . . . *Free Flow of Information*

The securities industry has contended for many years that, in practice, the free flow of information concerning a new issue during the waiting period has been restricted because of the fear of underwriters and dealers, not to mention their lawyers, that communications to prospective customers might be construed to be illegal "offers" of a security before the effective date of the registration statement. This fear springs from the criminal penalties provided for violation of the statute and also from the fact that a violation of Section 5, based on a strict construction of the term "offer", might give the purchaser a right of rescission for one year under Section 12 (1) of the Act.

The Securities and Exchange Commission recognized that the distinction between "dissemination of information" and an "offer" is difficult to draw and still more difficult for a customer to appreciate, and was concerned through the years because the objective of a widespread dissemination of information during the waiting period was not more effectively achieved.

Accordingly, the Commission took administrative actions designed to encourage issuers and underwriters to make it possible for dealers and prospective investors to become familiar during the waiting period with the information which the statute intended they should have.

From the earliest days of the Commission's administration of the Securities Act, pre-effective summaries of information as filed have been permitted.[1]

In 1946, the Commission adopted a rule (Rule 131)[2] which provided that distribution of a preliminary prospectus before the effective date of a registration statement should not in itself constitute an "offer". This preliminary prospectus, usually filed as part of the registration statement, was popularly called the "red herring" prospectus, because a legend was printed in red on each page stating that it was not an offer to sell or the solicitation of an offer to buy and that it was preliminary, not final.

Since adoption of Rule 131, the Commission's action in accelerating the effective date of a registration statement has been conditioned upon a showing that there had been an adequate and timely distribution of the "red herring" to dealers who were expected to participate in the sale of the security to the public.

This rule and administrative policy achieved in part the original statutory objective. Since that time, as a matter of practice, underwriters and dealers who expect to participate in the distribution of a new security receive information concerning the new issue by means of a "red herring" prospectus, in advance of the effective date.

The "red herring" prospectus, however, does not lend itself to distribution to the public generally for the purpose of preliminary screening of prospective customers. It frequently cannot be secured in sufficient quantity in various parts of the country in time to permit its general use as a means to disseminate information or as a means by which underwriters and dealers may determine public interest in a forthcoming issue.

In 1952, the Commission took another administrative step designed to assist dealers to communicate with customers for the purpose of determining who might be interested in receiving the prospectus concerning a new issue. A rule (Rule 132)[3] was adopted which provides for a short notice of proposed public offering called an "identifying statement" containing prescribed minimal general information concerning a new issue. This rule likewise provided that the use of the identifying statement should not constitute an "offer" of a security for purposes of Section 5. Under this rule, an issuer was required to file the identifying statement with its registration statement and the Commission conditioned its action in making the statement effective upon a showing that copies of the identifying statement had been made available to dealers and underwriters.

Underwriters and dealers objected that Rule 132 does not permit the inclusion in the identifying statement of sufficient information to stimulate inquiries by investors for copies of the prospectus. They contended that the identifying statement fails in its purpose unless it contains more of a summary of the registration statement, including a summary of certain financial information.

These rules and policies—that is, the rule concerning the use of the "red herring" prospectus and the use of the identifying statement, and the policy requiring the use of these documents—are consistent with the Act. However, in view of the precise and sweeping prohibitions of Section 5, in view of the difficulty in distinguishing between the dissemination of information and the making of an offer, and in view of the difficulty of explaining that the use of a "red herring" prospectus is not an offer of the securities, the legislation just enacted contains amendments of the Act which would expressly support the practices which the Commission permitted and indeed required the industry to follow.

Basically, the amendment will permit written offers to sell and solicitations of offers to buy during the waiting period by means of a preliminary prospectus filed with the Commission prior to its use. The present prohibition against the making of an actual sale or contract of sale of a security prior to the effective date of

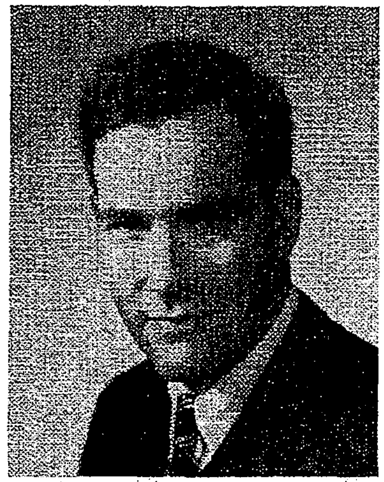
1. Securities Act Releases Nos. 464 and 802.
2. Securities Act Release No. 3177.
3. Securities Act Release No. 3453.

a registration statement is not affected by the amendment.

Issuers, underwriters and dealers should find no difficulty in regulating their conduct during the waiting period so as not to make contracts of sale before the registration statement becomes effective. This might be done by conditioning offers, limiting activity to solicitation of offers to buy or by other means which keep the transaction short of a sale or contract of sale. Contracts of sale or contracts to sell, not otherwise exempt, made effective upon the happening of a condition, as for example the becoming effective of the registration statement, would be illegal.

Chase

Ralph H. Demmler has been Chairman of the Securities and Exchange Commission since June of 1953. A native of Pittsburgh, Pennsylvania, he practiced in Pittsburgh until his appointment to the Commission. He was admitted to the Pennsylvania Bar after his graduation from the University of Pittsburgh Law School in 1928.



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J. Sinclair Armstrong was admitted to the Illinois Bar in 1941. He practiced in Chicago until he became a member of the Commission in July of 1953. During the war, he was assigned as a lieutenant (j. g.) to the Office of the General Counsel of the Navy. He is a graduate of Harvard College and of the Harvard Law School.

The New Amendment . . . *No Fundamental Change*

It must be apparent from what has just been stated that the amendment does not work any fundamental change; in fact, it may fairly be said to give more specific authority for the continuance of practices which have developed over the years under the present law, and to make those practices specifically subject to the sanctions provided by the Act.

To the extent the media of information which are permitted by the amendment are more widely disseminated, a larger segment of the investing public generally, and the smaller dealers, will have a greater opportunity to participate in the processes of capital formation.

No change is made in the provisions of Section 5 (a) (2) which prohibit the transmission of a security through the mails for purposes of sale or delivery after sale unless a registration statement is in effect.

The redefinition of "sale" to exclude offers (Section 2 (3)), together with the revision of Section 10 of the Act dealing with the contents of prospectuses, changes the effect of Section 5 (b) (1) of the Act to permit the making of offers during the waiting period by means of prospectuses containing summary information as well as by means of the "red herring" prospectus.

The provisions of Section 5 (b) (2) which require delivery of a complete prospectus in connection with a sale or delivery after sale are retained.

These changes made necessary a new Section 5 (c) which makes it unlawful to offer a security prior to the filing of a registration statement.

A conforming change in Section 10 is made so as to authorize the Commission to permit the use of a summary prospectus in addition to the conventional prospectus. This short-form summary prospectus will be filed with the Commission, as part of the registration statement, and must conform to the Commission's rules and regulations. In order to prevent the use of a summary prospectus which fails to meet the Commission's requirements, the Commission will be authorized to suspend the use of a defective summary prospectus. This administrative remedy, which is intended to supplement the stop-order powers of the Commission under Section 8, is considered essential because of the necessity for speedy action to prevent the use of a defective summary prospectus during the relatively short waiting period.

Since, however, the summary prospectus will involve condensation or summarization of the full prospectus and since that process necessarily involves omission, the amendment provides that preliminary and summary prospectuses authorized by this Section should not be subject to Section 11, which imposes liabilities upon the issuer, its officers, directors and underwriters for misstatements and omissions. This will not lighten the existing burden of liability because the "red herring" prospectuses permitted up to now are not subject, as such, to Section 11 liabilities. The administrative sanctions of Section 8 and the suspension power, coupled with the liabilities of Sections 12 and 17, which provide for civil liabilities and criminal penalties against sellers, can be relied upon to guard against the use of defective summary prospectuses.

As above stated, the prospectuses and summary prospectuses provided for by the amendment are to be filed with and processed by the Commission before being released to the public. Issuers, underwriters and dealers are not permitted to send out unprocessed sales literature prior to effectiveness of the registration statement. The amended law was not intended to permit pre-effective "free-writing."[4] However, under an amendment of Section 2 (10) (b) of the Act the so-called "tombstone advertisement" may be used, subject to Commission rules, to solicit inquiries for the prospectus or summary prospectus and may be used after the filing of the registration statement as well as after the effective date.

At the effective date of the amendment to the law, the Commission adopted some technical revisions of its rules to bring them into conformity with the new legislation.[5] These are of a "housekeeping" nature. A new rule (Rule 460) restates the requirements for preparation and distribution of preliminary prospectuses previously embodied in Rule 131 (discussed above), which was rescinded. The Commission is presently engaged in drafting new rules to implement all of the provisions of the amended acts, with particular emphasis on the rules for summary prospectuses and "tombstone" advertisements. These should be released for public comment within a short time.

One further change of substance in Section 10 should be mentioned at this point although it is not directly related to the Section 5 problem. Before amendment, Section 10(a) provided that a prospectus should contain the information contained in a registration statement and that when a prospectus is used more than thirteen months after the effective date of the registration statement, the information in such prospectus shall be as of a date not more than one year prior to its use.

The effect of these provisions was to require more current disclosure for prospectuses employed after the expiration of the first thirteen months of an offering than during the first thirteen months. This arises from the fact that some of the information in the registration statement at the time it becomes effective may be as of a date in some instances as much as six months prior to the filing. The requirement that the information in the later prospectus be as of a date within one year of its use has presented something of a problem in many instances because it required the preparation of interim certified financial statements—an expensive process.

The Section 8 of the amending Act provides that when a prospectus is used more than nine months after the effective date, the information in the prospectus shall be as of a date not more than sixteen months prior to such use. This will make for less discrimination between offers of short duration and those of long duration, without diminishing the quantity or quality of information supplied investors.

The next amendment relates to the use of prospectuses after the effective date of a registration statement. The law has required underwriters and dealers to deliver prospectuses to investors as long as they are engaged in the initial distribution of a security. Moreover, any dealer, even though not a participant in the distribution, had to deliver prospectuses to his customers in trading transactions for at least one year after commencement of an offering. The amendment (Section 6 of the amending Act amending Section 4(1) of the Act) provides for delivery of prospectuses in trading transactions during the actual offering period but in no case less than forty days after the effective date of the registration statement or forty days after the commencement of public offering, whichever expires last. It does not change the requirement that prospectuses be delivered by underwriters and dealers so long as they are engaged in the initial distribution of the security.

The one year provision with respect to trading transactions has long been recognized as unrealistic. Moreover, dealers trading in a security publicly offered within one year find themselves unable to obtain prospectuses. This fact rendered compliance by dealers and enforcement by the Commission difficult.

In view of the continuous offering of securities by certain types of investment companies, particularly those commonly referred to as "mutual funds", a special provision for mandatory use of prospectuses by dealers over a longer period is provided by an amendment to the Investment Company Act (Section 402 of the amending Act, amending Section 24(d) of the Investment Company Act of 1940).

The Act of 1934 . . . *Extension of Credit*

Turning to the Securities Exchange Act of 1934, the first amendment relates to the provision covering the extension of credit by dealers on new issues. Section 11(d)(1) of the Securities Exchange Act prohibits a person who is both a broker and a dealer from "taking into margin accounts new securities in the distribution of which he participated during the preceding six months". This was intended in part to restrain distributors from selling new issues of securities to their brokerage customers on credit. The apparent purpose was to provide that new issues would be initially placed with investors rather than with speculators. It is generally agreed, however, that the prohibition against extending credit for six months after the end of the offering period is unnecessarily long.

Section 201 of the amending Act reduces the six-month period to thirty days, but the amendment will not permit extension of credit by a member of the selling syndicate or group while the selling or distributing process is in progress or for thirty days thereafter. It is believed that Section 11 (d) as so amended will be sufficient to assure that new issues will be sold on a cash basis.

The next amendment, relating to "when issued" trading, is designed as essentially a technical amendment to remove an ambiguity in the law

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4. Form S-9 adopted July 21, 1954. Securities Act Release No. 3509.
5. Congressional Record, July 28, 1954, page 11886.

insurance proceeds are subject to estate tax in full if receivable by the executor of the insured; or, even though receivable by other beneficiaries, if the decedent possessed any incident of ownership, whether exercisable alone or in conjunction with any other person.

If the decedent possessed no incident of ownership and the insurance was receivable by beneficiaries other than the estate, the old law subjected the proceeds to estate tax to the extent the decedent had paid premiums (in proportion to total premiums). Premiums paid by the decedent before January 10, 1941, were ignored if the decedent thereafter had no incident of ownership.

The new Code provides in Section 2042 that the payment of premiums is immaterial. However, great care must be taken in proper planning in this area for a number of reasons including the interjection of the "Reversionary Interest" test.

Under the old Code, a reversionary interest was not an incident of ownership. Under the new Code, a reversionary interest, whether express or by operation of law, is an incident of ownership if the value of the reversion exceeds 5 per cent of the value of the policy immediately before death of the insured. Moreover, the technicalities of transfers in contemplation of death must be borne in mind. There are rumors that the time is not yet ripe to engrave these new estate tax provisions in stone for posterity.

VII. Payments in Connection with Pension and Profit-Sharing Plans

There are various changes in the new Code affecting the taxation of benefits or annuities paid in connection with pension or profit-sharing plans or otherwise by reason of employment. For example: Section 72 (d) provides a rule of convenience for annuities paid for partly by an employer and partly by an employee. If the employee's contributions are recoverable in three years or less, he can, in order to eliminate computations, first recover his cost tax free and then report all the balance as taxable income. Detailed discussion of such provisions is not within the objectives of this article.

The principal purpose of this article is rather to outline the basic pattern of the new provisions taxing income from insurance and annuities so that each problem of Mr. Howard, Mr. Johnson and Mr. Fox, and others like them, can be recognized readily and placed in its proper niche.

The Federal Securities Laws

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and to confirm the rule-making power of the Commission with respect to such trading.

We now come to the offering of debt securities. The Commission, in connection with rule changes to provide for more simple prospectuses for use in the public distribution of high-grade so-called institutional type debt securities, has been confronted with Section 305 (c) of the Trust Indenture Act of 1939 which required inclusion in the prospectus of the analysis of particular indenture provisions singled out by Section 305 (a) (2) of the Trust Indenture Act.[6] This requirement seems unnecessary in the light of the Commission's rule-making authority under the Securities Act to deal with disclosure problems and the amendment leaves the matter to such authority.

The amendment does not affect the substantive provisions of the Trust Indenture Act which continue to require that trust indentures contain the statutory provisions for protection of investors, for example, that there be independent indenture trustees with adequate resources and free of conflicting interests, who must report to security holders and take other affirmative action to preserve investors' rights under indentures and to protect their interests in the event of default.

Finally, the amending Act provides for simplified registration procedure for investment companies. Investment companies which engage in continuous offerings of their shares, as a matter of practice, file new registration statements under the Securities Act of 1933 about once each year in order to have registered shares available. Before amendment, Section 6 of the Securities Act provided that securities may be registered by filing a registration statement but did not provide for registering additional securities by amendment. Section 403 of the amending Act amends Section 24 of the Investment Company Act by adding a new subsection (e) which will permit such investment companies periodically to increase the number of shares registered under the Securities Act by amending their existing registration statements rather than by filing new registration statements. Paragraph (3) of this new subsection (e) will require that current information will be made a part of the registration statement and prospectus at appropriate intervals. There will be no departure from either the disclosure standards or the liabilities imposed upon sellers.

Because of continuous offering of securities by investment companies, an amendment to Section 24 of the Investment Company Act provides for mandatory use of prospectuses by dealers over a longer period than would be required under Section 4 (1) of the Securities Act as modified by Section 6 of the amending Act. Under the amending Act a dealer, whether or not participating in the distribution, must use the prospectus as long as the issuer is offering any securities of the same class as the security which is the subject matter of the dealer's transaction.

The above discussion is limited to the new Act and does not treat many proposals made by industry representatives during the course of the formulation of the legislation which were not made a part of it.

However, one provision of the legislation, as sponsored by the Administration and passed by the Senate,

6. Form S-9, adopted July 21, 1954, Securities Act Release No. 3509.

but eliminated by the House of Representatives, should be mentioned. As introduced, the bill would have increased from $300,000 to $500,000 the maximum amount of exemption from registration under the Securities Act which may be provided by rules of the Commission. The House of Representatives deleted this provision and the Senate acquiesced in the change. A principal reason cited for increasing the exemptive amount is the disproportionate expense of registration of small issues as to which witnesses who appeared before the two congressional committees testified, particularly representatives of the independent telephone industry.

In acquiescing in the House position, the Senate conferees, as stated by Senator Bush in moving the Senate's agreement on the Conference Report:

> concluded, however, that the objective of reducing the cost of financing businesses of small and moderate size can be achieved if the Commission should take administrative action under powers it already has under the statutes.[7]

Senator Bush referred favorably to the Commission's adoption of simplified registration forms for issuers offering securities to their employees[8] and for institutional grade debt securities.[9] Senator Bush introduced in the record a portion of a letter of Chairman Wolverton of the House Committee indicating the latter's sympathy with the proposal:

> that the Commission undertake all action appropriate with reducing the costs of registration, revising applicable forms, and specifying types of information to be included in the prospectus and consistent with maintaining the liabilities and remedies contained in the act for the protection of investors.[10]

The Commission in formulating rules to implement the new legislation is now considering the possibility of a short-form registration statement for small issuers and issues.

The basic purpose of the federal securities laws is that the investor shall have an opportunity to know the facts about what he is investing in. These laws do not insure against risk of loss. Insurance against risk of loss can only be provided by the fundamental soundness of the enterprise in which the investment is made. Under the American system the investor is allowed to choose, without interference by the national government, where he shall invest. This is one of the great virtues of the free enterprise system in this country.

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7. Congressional Record, July 28, 1954, page 11886.
8. Form S-8, Securities Act Release No. 3480.
9. Form S-9, Securities Act Release No. 3509.
10. Congressional Record, July 28, 1954, page 11886.

Standards for Bar Examiners

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an intimate familiarity with the problems of admission to the Bar, but it is not fair to require him to give up a substantial amount of his time for a very long period in the service of the bar admission system. It is not fair also, nor is it desirable, in most cases to continue year after year the same points of view with respect to the admissions system.

In most states the bar examiners serve without compensation, but receive their necessary expenses. Most states cannot afford to pay the examiners for the amount of time which they devote to their service on the committee; but in those states where the bar examiners are paid, obviously such compensation should not be based upon the number of applicants for admission. This latter practice can only have the tendency to encourage a large number of applicants to apply, and if the larger the number who pass means the higher the fee to bar examiners, the quality of the applicants cannot fail to be lowered.

A Vital Need . . . *An Adequate Staff*

I cannot emphasize too strongly the vital need to have an adequate staff to handle the problem of bar examinations. The preparation of questions, the taking of the examination, the grading of answers, and the preparation of statistics all demand persons who can devote their full time to the task. These individuals should devote their full time to the task because it is indeed a full time job.

The next proposals deal with standards for the bar examination itself. Everyone must agree that the purpose of a bar examination is to assure the public and the Bar that only those persons who are properly qualified to practice should be admitted to the legal profession. Inasmuch as the bar examination is administered by lawyers appointed by a bar association or by a higher court, the examination should demonstrate clearly that this purpose is carried out fairly and impartially and that the Bar is not, through this mechanism, taking steps to limit its members to a tight little union in which ability is subordinated to lower numbers.

The examination itself, to achieve the best results, should test the applicant's ability to reason logically, to make an accurate analysis of the problems presented to him, and to demonstrate a thorough knowledge of the fundamental principles of the